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September 10, 1992

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Ms. Donna R. Searcy
Secretary
Federal Communications Commission
Stop Code 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

RE: CC Docket No. 92-101

Dear Ms. Searcy:

On September 9, 1992, Bill Taylor of National Economic Research Associates, Inc. (NERA), Cheryl Helms of Pacific Bell, and I met with Chris Frentrup and Mike Mandigo of the Tariff Division to discuss issues presented in the Pacific Companies' pleadings in the above referenced proceeding.

The purpose of the meeting was to review Pacific's position regarding the adoption of SFAS 106 for ratemaking and the exogenous treatment under Price Caps of related costs. The attached written material was distributed and discussed.

In accordance with Section 1.1206(a)(1) of the Commission's rules, enclosed is an additional copy of this letter with the appropriate attachments. Please include the attached material in the above referenced proceeding.

Acknowledgement and date of receipt of this transmittal are requested. A duplicate letter is attached for this purpose.

Please contact me if you have any questions concerning this matter.

Respectfully submitted,

Sherry Herauf

Attachments
cc: Chris Frentrup
Mike Mandigo

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THE ECONOMIC EFFECTS OF FAS 106 ON FCC PRICE CAP REGULATED FIRMS

ECONOMIC ISSUES:

- Introduction
- Adoption for Ratemaking
- Exogeneity and Control of Costs
- Double-Counting
  - Effect of FAS 106 on GNP-PI
  - Effect of Medical Inflation

INTRODUCTION

- Accrual accounting for OPEBs recognizes economic costs of OPEBs; cash accounting does not.

  - Prices in regulated markets are based on accounting costs with cash accounting for OPEBs.

  - Prices in unregulated markets already reflect the economic costs of OPEBs and adoption of FAS 106 will not cause them to change.

- Prices for regulated and unregulated firms must be based on the same view of economic costs.

  - Intergenerational equity.

  - Competitive equity.

- Price-cap regulated firms should increase prices by the one-time difference in expense between cash accounting and accrual accounting for OPEBs.

  - Places price-cap firms where they would have been if price caps had begun under accrual accounting for OPEBS

  - Gives price-cap firms same incentive to control medical costs and OPEB benefit levels as they have to control wages.

ADOPTION FOR RATEMAKING

- Intergenerational equity: the matching principle

  - Each generation should pay the costs it causes to be incurred; otherwise, consumers are sent incorrect signals regarding consumption.

  - Economic costs incurred are measured by accrual accounting expenses, not cash accounting expenses. Cash and accrual expenses in any year can be very different due to such factors as (i) growth in demand, (ii) change in composition of factors of production, (iii) change in age composition of the labor force, (iv) difference between medical inflation, U.S. overall inflation, and telephone price inflation.

- Competitive equity

  - Incumbent firms in telecommunications markets should set prices that recover incremental costs; otherwise, potential entrants are sent incorrect signals regarding their ability to enter profitably.

  - Competitive trends in telecommunications markets make it impossible for a regulated firm under cash accounting to recover its unfunded liability in later years.

EXOGENEITY AND CONTROL OF COSTS

- To warrant Z-factor treatment, a change in costs must be beyond the control of the firm.

- We must distinguish <u>costs</u> that are beyond the control of the firm from cost <u>changes</u> that are beyond the control of the firm.

    - LECs control level of OPEB benefits to the same extent they control current and future wages.

    - LECs have no control over the decision of the FASB and the FCC to adopt accrual accounting for OPEBs.

    - Z-factor treatment is appropriate for the one-time effects of the adoption of accrual accounting for OPEBs, not for on-going changes in the level of OPEB benefits.

An example: A change that everyone agrees merits Z-factor treatment is a separations change. Here, the LEC is compensated for the effect of the separations cost <u>change</u> not for increases or decreases in costs subject to separations. Here, like in OPEBs, the LEC has full control over the level of interstate costs.

DOUBLE-COUNTING

WITH GNP-PI

(1) From price cap theory, Z-factor adjustment equals the difference between the effect of FAS 106 on the LEC and on U.S. industry in general.

(2) Regulated and cost-plus firms will increase prices in response to FAS 106 by the difference between accrual and cash accounting for OPEBs.

(3) Unregulated firms will make no change in prices in response to FAS 106 because their prices already reflect economic costs.

(4) We assume (conservatively) that all purchasers of regulated firms' output will pass through the higher prices in their output prices.

(5) The regulated sector is (conservatively) 10.49 percent of GNP.

(6) The annual accounting expense change in 1993 from adoption of FAS 106 is 1.1 percent.

(7) Therefore, the effect of FAS 106 on GNP-PI is less than 0.12 percent.

DOUBLE-COUNTING

OF MEDICAL INFLATION

Future medical inflation is an important component of the proposed Z-factor adjustment. In every year, medical inflation is part of the GNP-PI adjustment to the LECs' price cap. Won't the LECs double-recover any increase in medical costs?

No.

(1) There is no double-counting in 1993, so revenues equal costs.

The proposed one-time Z-factor adjustment (based in part on medical inflation) would bring the LEC's PCI to the level it would have been if it had begun price caps under accrual accounting for OPEBs. At this point, by assumption, its costs just equal its revenues.

(2) The price cap formula keeps revenues equal to costs.

The formula is designed so that if the LEC meets its productivity objective, the annual percentage change in costs is equal to the change in the PCI. In 1994, the PCI would be updated by [GNP-PI - X] where GNP-PI explicitly measures national output price growth (which includes medical inflation).

DOUBLE-COUNTING

OF MEDICAL INFLATION

(3) Thus there is no double-counting in 1994.

If the LEC just met its productivity target in 1994, its PCI would increase at the same rate as its costs. Since revenue equals costs in 1993, revenue will equal costs in 1994, and there is no double-counting of medical costs in 1994.

(4) Removing medical inflation from the GNP-PI in the price cap formula would lead to under-recovery of costs.

Let NMGNP-PI be the GNP-PI with medical inflation removed. If the 1993 PCI were updated by NMGNP-PI - X, the costs of an efficient firm (one that met its GNP-PI - X target) would increase faster than its PCI. Since revenues equalled costs in 1993, costs will exceed revenue in 1994.

SFAS 106
Employers Accounting For Postretirement Benefits Other than Pensions
Impact on Pacific Bell

Pacific Bell
September 9, 1992

Accounting For OPEBs

What are Postretirement Benefits Other than Pensions (OPEB)?

- They are any retirement benefits other than retirement income:

  Pacific Bell provides:
  - Medical Benefits Care (or health insurance)
  - Dental Benefits
  - Life Insurance

Past Accounting Practices

- Employers have generally accounted for OPEBs on a pay-as-you-go basis that recognizes benefit costs only when they are paid.

Accounting For OPEBs

New Accounting -- FASB Deliberations

- The Financial Accounting Standards Board (FASB) determined that pay-as-you-go accounting does not accurately attribute the true cost of OPEBs to the periods in which the benefits are earned.

- FASB determined that OPEBs are a form of deferred compensation, the cost of which should be recognized during the working lives of covered employees.

- FASB found that postretirement benefits represent a significant financial obligation that was not being reflected on employers' financial statements.

Accounting For OPEBs

SFAS 106 -- (Employers' Accounting For Postretirement Benefits Other Than Pensions)

- FASB issued a new accounting standard (SFAS 106), in December 1990, which mandates accrual accounting for OPEBs.

- SFAS 106 must be implemented by 1/1/93.

- The FCC authorized the adoption SFAS 106 in December 1991.

Accounting For OPEBs

SFAS 106 -- Practical Considerations

<u>The Unrecognized Embedded Liability</u>

- To catch up from cash to accrual accounting, it is necessary to book and expense a very significant liability. This embedded liability represents the previously unrecognized OPEBs for all current and retired employees as of 1/1/93.

- FASB allows the embedded liability to be recognized through an immediate write-off, or over 20 years, or over the period of average remaining service for active employees.

Accounting For OPEBs

SFAS 106 -- Practical Considerations (Continued)

- The FCC requires that the transition obligation be amortized over either the average remaining service period for active employees (15 years for Pacific Bell) or over 20 years.

Pacific Bell's 1993 Embedded Liability

- Pacific Bell's unrecorded OPEB liability will be at least $2.3 billion when the new standard is implemented.

Accounting For OPEBs

SFAS 106 -- Practical Considerations (Continued)

Higher Costs

- Pacific Bell's SFAS 106 accrual (about $390 million) will be twice as high as current accounting costs used for ratemaking (about $190 million).

Funding Reduces Growth Of OPEB Costs

- Pacific intends to fund over $280 million per year in tax advantaged VEBA trusts if rate recovery is granted.

- Even with aggressive funding, tax advantaged trust contributions will be less than the SFAS 106 accrual. If exogenous treatment is granted, it would be appropriate to reduce rate base by the portion of the accrual not funded.

Rate Recovery of Incremental SFAS 106 Costs

Rate Recovery

- Pacific Bell has requested recovery of the exogenous cost increase associated with adopting SFAS 106 effective 1/1/93.

- Currently recovering pay-as-you-go for managers and tax deductible funding for union employees - - about $30 million (interstate).

- Incremental price caps request- - $25 million (only $20 million initially included in rates).

Development of SFAS 106 Accrual

- SFAS 106 accrual was prepared by our in-house enrolled actuary.

- Pacific's direct case includes an Actuarial Report which identifies assumptions and methodologies used to develop the OPEB accrual.

- Pacific's SFAS 106 amounts have been certified by John M. Bertko, the senior health care actuary at Coopers & Lybrand. Mr. Bertko was the lead actuary on the Financial Executives Research Foundation Field Test of the FASB Exposure Draft on OPEBs. Because of the potential significant impact of the new accounting standard, C&L was engaged by FASB to design and perform a comprehensive study of the effects of the proposed standard on the financial statements of 25 of the nation's largest companies. Mr. Bertko served as Chairman of the Retiree Health Benefits Subcommittee of the American Academy of Actuaries. He is an enrolled actuary, a Fellow of the Society of Actuaries and a Member of the American Academy of Actuaries.

Pacific Bell
Impact of SFAS 106

Key Actuarial Assumptions

- Medical Cost Trend Rate.

Year	In-Network	Out-of Network
1990-1993	12.00%	14.00%
1994	11.50%	13.00%
1995	8.50%	13.00%
1996	8.00%	10.00%
1997	7.50%	9.00%
1998	7.00%	8.00%
1999	6.75%	7.50%
2000	6.50%	7.00%
2001	6.25%	6.50%
2002+	7.00%	6.00%

September 9, 1992

Key Actuarial Assumptions

- Discount Rate -- 8.5% (consistent with SFAS 87)

- Return on Trust Funds

Bargained VEBA Trust	8.5%
Non-bargained VEBA Trust	5.0%
Group Term Life VEBA	8.5%

- Substantive Plan

  Assumes that a significant share of future medical inflation will be borne by retirees.

Pacific Bell
Impact of SFAS 106

Interstate Impact of SFAS 106
Dollars In Millions

		1993
1)	SFAS 106 Accrual	$59.5
2)	OPEB Cost Recovery -- Current Methodology	30.1
3)	SFAS 106 Incremental Rate Base Impact	0.6
4)	Net Increase (L1 - L2 - L3)	28.8
5)	GNP-PI Effect (6.26%* X L4)	1.8
6)	Total Z Factor Adjustment (L4 - L5)#	27.0
7)	Billing and Collection Allocation	1.6
8)	Net Price Cap Increase (L6 - L7)	25.4
9)	Amount Included In Proposed Rates	$20.0

* Per NERA Study, Page 32
\# Per Transmittal Letter No 1579, Work paper II

September 9, 1992